United States Senate

WASHINGTON, DC 20510

March 18, 2003

Mr. William H. Donaldson
Chairman
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Dear Chairman Donaldson

As you know, at its Board meeting on Wednesday, the FASB added a project on employee stock options to its agenda. The brief discussion that occurred on valuation made clear that measurement and valuation issues remain unsolved. Despite those formidable challenges, the FASB seems intent on moving quickly. We are concerned that the FASB may pursue a *potentially flawed* outcome rushed through without the benefit of an objective and deliberative rulemaking process based on all the facts.

For these reasons, we respectfully request that the SEC conduct a prompt but careful study of the unique factual record on this issue to determine whether the expensing of stock options based on the most widely used "fair value" approach – the so-called Black-Scholes method – has, in fact, generated accurate or inaccurate information for investors. Indeed, the quantity and quality of comment letters recently submitted to the FASB bring to light the danger that existing fair value approaches generate highly subjective and inaccurate numbers that will very likely work against investors' interests. This study, and a report detailing the Commission's findings, should be completed, in our view, to help inform FASB prior to any FASB rulemaking to modify the existing accounting standard for employee stock options, if one is to proceed.

Specifically, we request that the SEC examine footnote disclosures authorized by the FASB through SFAS 123 that estimated the fair value of employee stock options based on Black-Scholes or binomial models. The nearly 10-year record that exists through public company filings with the SEC allows it to determine the degree to which those estimates proved to be accurate. Indeed, we are fortunate to be able to assess whether a fair value approach to expensing stock options produces reliable and transparent information to investors and other users of financial statements.

In conducting this study, we suggest that the SEC present its findings that show the percentage of footnotes that proved to be 100% accurate, as well as those showing other ranges, such as:

5-10% degree of error, whether higher or lower;
10-25% degree of error, whether higher or lower;
25-50% degree of error, whether higher or lower;
50-75% degree of error, whether higher or lower;
75-100% degree of error, whether higher or lower; and
more than a 100% degree of error.

Such data will enable investors and other financial statement users to know whether predictions based on option pricing models such as Black-Scholes or other fair value methods are accurate and reliable, as well as the degree to which they are not. Chairman Herz recently defended mandatory expensing by asserting that it was better to be "kinda right than precisely wrong." (Interview with Kudlow and Cramer, CNBC, February 5, 2003). A study by the SEC prior to FASB rulemaking would contribute valuable data as to whether fair value estimates are, in fact, "kinda right" or whether they are "precisely wrong."

This study is made all the more important by the new requirements imposed by the Sarbanes-Oxley Act that CEOs and CFOs certify the accuracy of their company's financial statements. There can be little doubt that financial and accounting professionals and other experts have fundamental concerns about the ability to accurately value stock options. Even companies that have expressed an intent to expense have raised these concerns. The SEC obviously should help ensure accurate accounting standards and evaluating the data would be a constructive contribution. Regardless, the commission must ensure that CEOs and CFOs are not faced with the Hobson's choice of either refusing to follow a FASB standard or to follow it and then certify numbers that may well prove to be materially inaccurate, thereby subjecting themselves to criminal and civil liability.

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The debate about the mandatory expensing of employee stock options is a longstanding one – precisely because the underlying accounting issues are complex, and the risks of presenting inaccurate numbers to investors are great. We ask that the SEC undertake this comprehensive study to provide the type of experience-based factual information that is currently missing but so fundamental to responsible rulemaking and investor protection. We believe that investor protection now demands that the SEC undertake this important research to ensure that any decision-making by the FASB is based on an impartial review of all the facts.

Sincerely,